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SUBJECT: Central Bank Governor Stays focused on Inflation

11. (SBU) Summary: The Central Bank of Turkey (CBRT) noted in its recent inflation report that the Government should restrain spending to help the CBRT meet its inflation target this year. CBRT Governor Durmus Yilmaz affirmed this view to us, and noted that the CBRT has not changed its stance despite the current global market volatility and the expected impact of a bad harvest on food prices. Yilmaz said external factors are the biggest threat to price stability and said the CBRT was closely monitoring Turkey's current risks. End Summary.

12. (SBU) Central Bank Governor Durmus Yilmaz met with us on July 30. The meeting coincided with ongoing global market turbulence as global portfolio investors work to lower their risk profile by pulling out of emerging markets. Governor Yilmaz said the CBRT is fully aware of the local risks for Turkey as well as risks arising from global developments. Yilmaz said that inflation is still trending downward but any interest rate cut will have to wait until he has data confirming this trend and the medium term inflation outlook. The Central Bank currently keeps its simple annual policy rate at 17.50% (19.12% on compound annual basis) with real interest rates around 8-9%.

13. (SBU) In his public statements on July 27, the Governor said the CBRT might increase the reserve requirement ratio for banks if it perceived excessive credit expansion in the economy. Yilmaz said CBRT was watching demand-side pressures very closely.

14. (SBU) Yilmaz noted that it was too early to relax on the disinflation process in part because of increased government spending before the July elections that constituted a risk to price stability. Yilmaz also said that external risk factors now are of more concern than domestic--and that the current "global credit market problem" could be a major risk for Turkey. Since the CBRT has no control over these factors, it is even more important for the government to control spending and for the CBRT to be very cautious in cutting interest rates.

15. (SBU) The Central Bank has been under attack from exporters and some government figures because of the strength of the Turkish Lira. Yilmaz said that the CBRT's policy is to bring inflation down and keep it within its inflation targets. The appreciation of the lira is a by-product of the CBRT's anti-inflation policies and increased confidence in the economy. Yilmaz emphasized that the CBRT does not target or set exchange rates. When asked whether the bank was receiving any political pressure, the Governor said that the CBRT had to listen to government concerns, but should not deviate from its inflation targeting policy under pressure.

16. (SBU) Increased public spending before the elections caused budget balances to deteriorate and may cause the primary surplus

ratio to go as low as 5% of GDP this year, versus the 6.5% annual target. The Central Bank publicly recommended that the Government introduce some spending measures to stay within budget limits. The Governor said that there was sufficient coordination among state agencies, especially between the Central Bank and the Treasury. Treasury has non-voting representation and shares information at the Monetary Policy Committee (MPC) meetings. There are also regular market maker meetings held between banks, the Central Bank and the Treasury.

7.(SBU) The Governor said inflation was showing a downward trend and the bank estimated the year-end mid-point of the expected inflation range to be 6% for 2007 under an assumption of easing in policy rates in the last quarter. As a result of the hot weather conditions and a poor harvest caused by the current drought, unprocessed food prices remain a threat to prices for the remainder of the year. The Central Bank carries out regular in-house surveys and the recent July 10 survey was pointing to higher food prices. The CBRT also expects a higher inflation reading for August and September due to seasonal factors like increased school spending.

18. (SBU) Comment: Turkey has come a long way on the economic policy front in the past six years, bringing inflation down from 70% per year to around 9-10%. The move to a formal inflation targeting regime in January 2006 commits the CBRT to reducing the annual inflation rate to 3-4%. Governor Yilmaz is signaling that restraint on government spending is a necessary, but not sufficient, condition for interest rates to come down. Even if spending does moderate, the CBRT may not cut rates until after it sees food and energy price data. His willingness to call publicly for Government fiscal restraint before he will consider an interest rate cut is a noteworthy exercise of CBRT independence, given the intense political pressure on the bank and the government to ease monetary policy to avoid an overly-strong lira. The Governor believes that the government plays a key role in shaping price expectations and

ANKARA 00002052 002 OF 002

any CBRT announcement regarding future measures will have an immediate impact on wage/price setters. End Comment

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